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VIA ELECTRONIC SUBMISSION

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
regs.comments@federalreserve.gov

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
comments@FDIC.gov

Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219
regs.comments@occ.treas.gov

Re: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts

CME Group Inc. (“CME Group”)¹ is the parent of the Chicago Mercantile Exchange Inc. (“CME”). CME is registered with the Commodity Futures Trading Commission (“CFTC”) as a derivatives clearing organization (“DCO”) and is one of the largest central counterparty (“CCP”) clearing services in the world. CME’s clearing house division (“CME Clearing”) offers clearing and settlement services for exchange-traded futures and options on futures contracts, as well as over-the-counter (“OTC”) derivatives transactions, including interest rate swaps (“IRS”) products. On July 18, 2012, the Financial Stability Oversight Council designated CME as a systemically important financial market utility (“designated FMU”) under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

CME Group appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, Treasury (“the Agencies”) proposal to implement the *Standardized Approach for Calculating the*

¹ As a leading and most diverse derivatives marketplace, CME Group enables clients to trade futures, cash and OTC markets, optimize portfolios, and analyze data - empowering market participants worldwide to efficiently manage risk and capture opportunities. CME Group exchanges offer the widest range of global benchmark products across all major asset classes based on interest rates, equity indexes, foreign exchange, energy, agricultural products and metals. The company offers futures trading through the CME Globex platform, fixed income trading via BrokerTec and foreign exchange trading on the EBS platform. In addition, it operates one of the world’s leading central counterparty clearing providers, CME Clearing. With a range of pre- and post-trade products and services underpinning the entire lifecycle of a trade, CME Group also offers optimization services through TriOptima, and trade processing and reconciliation services through Traiana.

Exposure Amount of Derivative Contracts (“the Proposal”).² CME Group previously participated in the request for comments with respect to the supplemental leverage ratio (“SLR”) in response to the proposals published in April 2018.³

Rather than debate the relative merits of standardized approach for counterparty credit risk (“SA-CCR”) versus the current exposure method (“CEM”), CME Group’s focus continues to be the inappropriate formulation of the SLR framework where there is no provision for bank and bank-affiliated clearing members to offset their leverage exposure for client cleared derivatives with segregated client initial margin (i.e., segregated client initial margin offsets). The current SLR formulation creates systemic risk due to the inability to recognize the exposure reducing nature of segregated client initial margin. Since the introduction of the SLR, centrally cleared derivatives markets have observed an increased concentration in client clearing. This concentration coupled with the implications of the current SLR for managing a market stress event serves to unnecessarily increase systemic risk, in part by undermining the likelihood of successful porting of the clients of a defaulted clearing member.

Regardless of the leverage exposure calculation methodology, adopting client initial margin offsets in the SLR aligns with both the legislative intent underlying the Dodd Frank Act and the G20 Leaders’ policies to promote the use central clearing. At the same time, the adoption of client initial margin offsets will continue to support the resilience of the banking system by preventing excessive build-up of leverage. In particular, a revision to allow segregated client initial margin offsets under the SLR framework would lessen the capital constraints being imposed on the provision of client clearing services in U.S., an activity which reduces systemic risk. Unfortunately, the fact that the current SLR design originates from uncleared OTC market convention has resulted in the perverse outcome where banks are incentivized to allocate capital to business lines that have higher risk. The SLR was not designed to limit the allocation of capital to risk-reducing services, such as client clearing. Instead, it was intended to act as a backstop to risk-based capital requirements. Our analysis confirms our supposition that providing client initial margin offsets will significantly benefit client clearing without any negative implications associated with the build-up of excessive leverage as it results in a nominal change to tier 1 capital requirements at the bank holding company level.⁴

Question 17: The agencies invite comment on the recognition of collateral provided by clearing member client banking organizations in connection with a cleared transaction for purposes of the SA-CCR methodology. What are the pros and cons of recognizing such collateral in the calculation of replacement cost and potential future exposure? Commenters should provide data regarding how alternative approaches regarding the treatment of collateral would affect the cost of clearing services, as well as provide data regarding how such approaches would affect leverage capital allocation for that activity.

² 83 FR 64660.

³ 83 FR 17317.

⁴ Please refer to the analysis in response to the Proposal that CME Group submitted on a confidential basis as Appendix I.

CME Group believes analysis performed by market stakeholders, including international standard setters and local regulators, has provided clear and convincing evidence that the SLR should be revised to recognize the exposure reducing impact of segregated client initial margin for centrally cleared derivatives while demonstrating that the failure to do so has had negative impacts on these markets and, thus systemic risk.⁵ We note that we are not alone in holding this view, as we have observed U.S. policy-makers consider implementing changes to U.S. legislation and regulatory requirements to address the negative effects of the current SLR framework.⁶ To complement this work, we have prepared quantitative analysis submitted on a confidential basis for the Agencies review as Appendix I.

The adoption of client initial margin offsets in the SLR would strengthen the resilience of the U.S. financial system by encouraging the use of the risk mitigation benefits of centrally cleared derivatives while continuing to prevent the build-up of excess leverage in the banking system. The application of segregated client initial margin offsets would reflect the confidence U.S. policy-makers demonstrated in the market structure for client cleared derivatives, by accurately recognizing the fundamental role of client initial margin as a source of exposure mitigation, rather than leverage. The role of centrally cleared derivatives markets as reducing systemic risk and acting as a safe haven in times of market stress during the financial crisis drove the G20 Leaders' and U.S. policy-makers' policy objective to promote the use of central clearing. To date, the SLR has undermined this objective.

As noted in the confidential data we submitted as Appendix I, the adoption of segregated client initial margin offsets would have a nominal impact on tier 1 capital requirements at the bank holding company level, though it would provide significant improvements to the ability of bank and bank-affiliated clearing members to offer client clearing. However, it is important to understand that many bank holding companies allocate capital based on the constraints at the business line or even trading desk level. Thus, the SLR may be binding at a more granular level than the bank holding company level based on the bank's allocation decisions.⁷ Given how bank holding companies allocate capital, it is critical that

⁵ See Jonathon Acosta-Smith, Gerardo Ferrara & Francesc Rodriguez-Tous, *The impact of the leverage ratio on client clearing*, Staff Working Paper No. 735 (June 2018), available at <https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/the-impact-of-the-leverage-ratio-on-client-clearing.pdf>; Basel Committee on Banking Supervision, Committee on Payments and Market Infrastructures, Financial Stability Board, and International Organization of Securities Commission, final report, *Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms* (Nov. 2018); J. Christopher Giancarlo, Chairman Commodity Futures Trading Commission, *Changing Swaps Trading Liquidity, Market Fragmentation and Regulatory Comity in Post-Reform Global Swaps Markets* (May 10, 2017), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22>; Richard Haynes, Lihong McPhail & Haoxiang Zhu, *CFTC Policy Brief - Assessing the Impact of the Basel III Leverage Ratio on the Competitive Landscape of US Derivative Markets: Evidence from Options* (June 2018), available at https://www.cftc.gov/sites/default/files/About/Economic%20Analysis/oce_leverage_and_options.pdf; U.S. Department of Treasury, *A Financial System that Creates Economic Opportunities: Capital Markets* (Oct. 2017).

⁶ H.R. 4659, 115th Cong. (2018); S. 3682, 115th Cong. (2018).

⁷ See Basel Committee on Banking Supervision, Committee on Payments and Market Infrastructures, Financial Stability Board, and International Organization of Securities Commission, final report, *Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms* (Nov. 2018).

different capital requirements are appropriately capturing the true exposures of activities. Making low exposure, low return activities, such as client clearing services, inappropriately expensive will restrict the capital allocation to such activities, resulting in capital allocation to other activities which could increase risk in the overall financial system.

Market Structure for Centrally Cleared Derivatives

In the case of centrally cleared derivatives, the role of a clearing member providing client clearing services must be understood and accurately accounted for in the SLR's design. Clearing members act as agents for their clients to the DCO and guarantee their clients' performance to the DCO, assuming payment obligations associated with a client default. Clearing members mitigate their potential future exposures to their clients through the collection of initial margin.

Under the U.S. regulatory regime enforced by the CFTC, a futures commission merchant ("FCM") (i.e., client clearing members for U.S. based derivatives markets) collects initial margin directly from its clients on a segregated basis and such margin may only be used to offset the client exposure guaranteed by the FCM. Client initial margin resources are held in a segregated account separate from the FCM's own funds and the vast majority of such resources are passed on to the DCO, where segregation is maintained. Our analysis indicates that in excess of 80% of client initial margin is passed from the FCM to the DCO, where it remains outside the ownership and moves outside the control of the FCM. We note that initial margin deposited with the DCO is held in a manner consistent with the requirements for collateral to offset securities financing transaction exposures under the Agencies' capital adequacy minimum capital requirements.⁸

Systemic Risk Implications of the Current SLR

The reduced availability of client clearing services due to the current SLR calibration has been widely publicized within the derivatives industry and consistently affirmed by market participants and policy-

⁸ 12 CFR 3.10 (c)(4)(ii)(F); 12 CFR 217.10 (c)(4)(ii)(F); 12 CFR 324.10 (c)(4)(ii)(F).

makers.^{9,10} Many clearing members have discontinued offering client clearing services since the implementation of the post-crisis financial regulatory reforms, as can be observed from the declining number of FCMs. The lack of availability of client clearing has made it challenging for end-users to rely on central clearing services to manage their risks. This can result in significant real economy impacts because end-users rely on clearing services to hedge their business risks, ultimately impacting the costs of consumer staples and asset management services relied upon by retirees, among other effects.

Further, the concentration of client clearing among clearing members presents systemic risk challenges. CME Group is concerned that the ongoing capital pressures resulting from the inappropriate formulation of the SLR may exacerbate market stress events by making it more challenging to port a large client portfolio. It is particularly unfortunate that additional systemic risk concerns have been created by the post-crisis reforms that were designed with the intention of promoting the resilience of the U.S. financial system. Historically, CME Clearing and other U.S. DCOs have successfully ported the exchange-traded derivatives owned by clients of a distressed clearing member, including during the financial crisis. The SLR challenges these past successes. To date, the potential negative impact of the SLR on client

⁹ See Justin Baer & Juliet Chung, [Goldman Sachs Cuts Roster of Hedge-Fund Clients](https://www.wsj.com/articles/goldman-rethinks-services-it-provides-hedge-funds-1407194493), Wall Street Journal, Aug. 4, 2014, available at <https://www.wsj.com/articles/goldman-rethinks-services-it-provides-hedge-funds-1407194493>; Kelly Bit & Michael Moore, [BoFA Said to Oust 150 Hedge Fund Clients Under New Rules](https://www.bloomberg.com/news/articles/2015-01-13/bofa-said-to-oust-150-hedge-fund-clients-under-new-rules), Bloomberg, Jan. 13, 2015, available at <https://www.bloomberg.com/news/articles/2015-01-13/bofa-said-to-oust-150-hedge-fund-clients-under-new-rules>; Aaron Woolner, [Credit Suisse Slashes Asia Commodity Futures Clearing Business](http://www.risk.net/asia-risk/news/2411383/credit-suisse-slashes-asia-commodity-futures-clearing-business), June 3, 2015, available at <http://www.risk.net/asia-risk/news/2411383/credit-suisse-slashes-asia-commodity-futures-clearing-business>; Luke Clancy, [Are regulators listening at last on the leverage ratio?](http://www.risk.net/risk-magazine/special/2423199/are-regulators-listening-at-last-on-the-leverage-ratio), Risk.net, Aug. 25, 2015, available at <http://www.risk.net/risk-magazine/special/2423199/are-regulators-listening-at-last-on-the-leverage-ratio>; Hayley McDowell, [Self-clearing gains traction as banks continue to downsize clearing units](http://www.thetradenews.com/Post-trade/Self-clearing-gains-traction-as-banks-continue-to-downsize-clearing-units/), Trade News, Jan. 31, 2017, available at <http://www.thetradenews.com/Post-trade/Self-clearing-gains-traction-as-banks-continue-to-downsize-clearing-units/>; Laura Noonan & Joe Rennison, [Deutsche Bank walks away from US swaps clearing](https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655?ftcamp=engage%2Femail%2Fnewsletters%2Fsmart_brief%2Fsmartbriefnewsletterscontrafcf%2Fauddev&segid=0800933), Financial Times, Feb. 9, 2017, available at https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655?ftcamp=engage%2Femail%2Fnewsletters%2Fsmart_brief%2Fsmartbriefnewsletterscontrafcf%2Fauddev&segid=0800933; James Rundle, [Clearing portability under threat as FCM pool shrinks](http://www.risk.net/risk-management/3912341/clearing-portability-under-threat-as-fcm-pool-shrinks), Risk.net, Feb. 23, 2017, available at <http://www.risk.net/risk-management/3912341/clearing-portability-under-threat-as-fcm-pool-shrinks>.

¹⁰ See Stafford Philip, [BoE backs derivatives leverage ratio rethink](https://www.ft.com/content/320829d8-42b7-11e6-b22f-79eb4891c97d), Financial Times, July 5, 2016, available at <https://www.ft.com/content/320829d8-42b7-11e6-b22f-79eb4891c97d>; J. Christopher Giancarlo, Chairman Commodity Futures Trading Commission, [Changing Swaps Trading Liquidity, Market Fragmentation and Regulatory Comity in Post-Reform Global Swaps Markets](https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22) (May 10, 2017), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22>; Basel Committee on Banking Supervision, Committee on Payments and Market Infrastructures, Financial Stability Board, and International Organization of Securities Commission, final report, *Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms* (Nov. 2018); FIA SmartBrief, [Quarles: Put derivatives-clearing offset in capital rules](https://www2.smartbrief.com/servlet/encodeServlet?issueid=6E84EBB7-E36E-4ABE-8656-8FE70FB711ED&sid=af5dae03-0b0a-449d-a2fc-f7f0eaaff89a), MLex, Nov. 16, 2018, available at <https://www2.smartbrief.com/servlet/encodeServlet?issueid=6E84EBB7-E36E-4ABE-8656-8FE70FB711ED&sid=af5dae03-0b0a-449d-a2fc-f7f0eaaff89a>; Brian Quintenz, Commodity Futures Trading Commission Commissioner, [Statement before Market Risk Advisory Committee](https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement120418) (Dec. 4, 2018), available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement120418>.

porting has not been tested, but that shouldn't stop proactive reforms to address this risk solely created by regulations.

For background, in the event of an FCM clearing member default, a DCO generally seeks to port the non-defaulting clients of the defaulting FCM clearing member. The lack of recognition of segregated client initial margin under the SLR ignores the fact that this margin is essential to the non-defaulting FCM clearing member's decision to accept ported clients. In effect, the capital charge that the FCM clearing member will incur because of its decision to accept ported clients has no correlation to the actual exposure the non-defaulting FCM clearing member takes on during the default management process. The consequence of this is an increased likelihood of client portfolio liquidation in the event of an FCM clearing member default because non-defaulting FCM clearing members will be unable or unwilling to accept clients for porting. The unnecessary liquidation of these client portfolios will likely serve to elevate overall systemic risk by exacerbating volatility of what is likely to be an already stressed market. Such volatility could lead to further defaults and increased stress on the DCO and the U.S. financial system more generally, creating a domino effect. These systemic risk challenges could be easily avoided through the implementation of segregated client initial margin offsets, which recognizes the market structure for centrally cleared derivatives.

Conclusion

The adoption of offsets for segregated client initial margin reduces systemic risk in three fundamental ways. It increases the ability of clients to utilize the exposure mitigation benefits of clearing, increases the likelihood of successful porting in a clearing member default and reduces the likelihood that banks will allocate their capital to higher risk activities. CME Group strongly advocates for the adoption of a revision to the SLR to recognize the market structure for centrally cleared derivatives by allowing segregated client initial margin to offset leverage exposure.

We would be happy to further discuss this letter, and/or answer any questions the Agencies may have related thereto. If you have any comments or questions regarding this submission, please feel free to contact me at +1 312 634-1592 or Sunil.Cutinho@cmegroup.com. Alternatively, you may contact Sean Downey at +1 312 930-8167 or Sean.Downey@cmegroup.com.

Sincerely,



Sunil Cutinho
President, CME Clearing
Chicago Mercantile Exchange, Inc.
20 South Wacker Drive
Chicago, IL 60606